Goodwill impairment valuation insights

Frequently asked questions

April 10, 2020

In March 2020, the severity of the COVID-19 pandemic rapidly escalated leading to numerous economic challenges. While the long-term impacts are still unknown, it is expected that many U.S. companies will experience declining earnings and asset values prompting the need to assess goodwill, among other assets, for potential impairment. Given that goodwill impairment will be top-of-mind for many companies, we have addressed a number of questions that typically arise when performing goodwill impairment tests in economic downturns.

Can a company use an average stock price when reconciling to market capitalization?

Generally, yes. The SEC staff has stated that in volatile market conditions it may be appropriate, in many cases, for management to consider the market capitalization based on an average share price over a reasonable period as a better estimate of the fair value of a reporting unit (or a company). We believe that guidance continues to be relevant in the current environment.

> When a registrant is evaluating an appropriate control premium, I believe that an important factor to consider is their recent trends in market capitalization. Note that I said recent trends in their market capitalization. Especially in volatile markets, and other unique circumstances, it may not always be reasonable to look at a single day's market capitalization. In some cases, I believe it would be more reasonable to look at market capitalization over a reasonable period of time leading up to the date at which you are testing for potential impairment. However, I would also note that it would not be reasonable for a registrant to simply ignore recent declines in their stock price, as the declines are likely indicative of factors the registrant should consider in their determination of fair value, such as a more than temporary repricing of the risk inherent in any company's equity that results in a higher required rate of return or a decline in the market's estimated future cash flows of the company.[1]

Given the sudden volatility in current market prices, it may be challenging to determine what period of time would be considered a 'reasonable' period. Generally, the reasonable period used in averaging the stock price will precede and lead up to, but not go past, the measurement date (e.g. March 31, 2020).

Due to the timing of recent events and volatility, it would generally not be appropriate for a company to use an average that includes dates before the recent downturn. For example, it likely would not be appropriate to use average prices for the entire quarter

[1] Excerpt from: Remarks before the 2008 AICPA National Conference on Current SEC and PCAOB Developments (Robert G. Fox III, Professional Accounting Fellow, Office of the Chief Accountant U.S. Securities and Exchange Commission) https://www.sec.gov/news/speech/2008/spch120808rgf.htm

ended March 31, 2020. Since markets reached all-time highs towards the end of February 2020 and the COVID-19 related decline occurred relatively quickly, we believe the appropriate period to capture for purposes of averaging might encompass days or weeks, but not months. In subsequent periods, a different average may be appropriate. In any case, a reasonable period of time should not be established with the intent to avoid an impairment.

The length of the averaging period will also depend on company-specific facts and circumstances. For example, it may not be appropriate to consider prices in periods before certain entity-specific events (e.g. loss of key customers, revision(s) in earnings guidance, or reductions in force) as the change in price may be related to factors other than volatility in the capital markets.

In any case, we would expect a company to prepare robust documentation of its key judgments in determining the averaging period.

Can a company use market prices after the reporting date in its average market price?

Generally, no. Changes in market prices after the reporting date should not be considered in determination of average market prices. Those changes do not reflect conditions at the reporting date; therefore, they are generally a non-recognized subsequent event. However, such changes may require a company to reevaluate whether all conditions existing at the reporting date were considered.

How does a company determine a MPAP (or control premium) in the current environment?

From a high level, the MPAP is best corroborated by specific, comparable and current industry transactions. If there is no (or limited) current market activity to support the MPAP, historical transactions may need to be considered. Given the sudden decline in the equity markets, we generally expect that control premiums will increase compared to historical premiums. However, companies should avoid applying control premiums based on arbitrary 'rule of thumb' percentages or backing into a premium that avoids an impairment loss.

At a more detailed level, MPAPs can be a topic of increased debate in periods of significant stock price declines. In particular, when public markets exhibit widespread downward trends, it can become difficult to reconcile to the observed market capitalization under a "normal" MPAP. Therefore, consensus regarding the range of acceptable MPAPs becomes critical under these circumstances.

It is important to consider how MPAPs may be influenced by the economic cycle. As shown in the following table, MPAPs tend to be higher in periods of financial downturns. For these reasons, when selecting a MPAP in the current market, it may be prudent to also consider comparable transactions from the 2008-2009 financial crisis or the relative magnitude of the differences compared to recent control premiums.

Observed BEV[2] MPAPs			
Percentile	**2018-19**	**2008-09**	**Difference**
25.0%	13.1%	22.5%	9.4%
50.0%	23.8%	38.1%	14.3%
75.0%	40.2%	60.0%	19.8%
90.0%	67.4%	102.9%	35.4%

The SEC staff has noted that the amount of the control premium "can require a great deal of judgment" and "a registrant needs to carefully analyze the facts and circumstances of their particular situation when determining an appropriate control premium and that there is normally a range of reasonable judgments a registrant might reach." Additionally, the SEC staff noted that it is their expectation that the amount of evidence supporting management's judgment would increase as the control premium increases:

> "I would also note that the amount of supporting evidence supporting your judgment would likely be expected to increase as any control premium increases."[3]

As the MPAP increases, the transaction support should be reviewed in detail to assess comparability. In these cases, a detailed analysis of the qualitative factors referenced in the Appraisal Foundation's Valuations in Financial Reporting Valuation Advisory 3: The Measurement and Application of Market Participant Acquisition Premiums can be helpful. One should also consider the factors described in 4.83 of the AICPA Accounting and Valuation Guide – Testing Goodwill for

[2] Business Enterprise Value (BEV)= Equity Market Capitalization + Fair Value of Debt – Cash

[3] Excerpt from: Remarks before the 2008 AICPA National Conference on Current SEC and PCAOB Developments (Robert G. Fox III, Professional Accounting Fellow, Office of the Chief Accountant U.S. Securities and Exchange Commission) https://www.sec.gov/news/speech/2008/spch120808rgf.htm

Impairment that could lead to potential differences between the estimated fair value and the observed market capitalization of the business. In situations where the MPAP significantly influences an impairment decision or falls at the upper end of the observed range for the industry, additional quantitative analyses may be needed as well.

We believe the SEC staff's historical views provide relevant insight in light of current market conditions. The determination of a reasonable control premium will require judgment and consideration of the company's specific facts and circumstances and available comparable transactions. When using a MPAP at the higher end of the range, more time will likely be spent supporting this assumption. Often this is done by quantifying the present value of market participant synergies that can be realized from the acquisition of the subject company.

For further guidance, companies can refer to the following sources:

— Appraisal Foundation, Valuations in Financial Reporting Valuation Advisory 3: The Measurement and Application of Market Participant Acquisition Premiums; and

— AICPA, Accounting and Valuation Guide: Testing Goodwill for Impairment

How does a company adjust discounted cash flow models to reflect the impact of COVID-19?

Given the uncertainties in the current environment, we expect that companies will adjust both the future expected cash flows and the discount rate for the increased risk factors when compared to analyses in more stable market conditions. Further, given the current uncertainties, it may be necessary to incorporate a COVID-19 company specific risk premium (CSRP) in the cost of equity estimate. In addition to the discount rate and financial projections, the long-term growth rate (LTGR) is another assumption that may be impacted by the COVID-19 crisis; therefore, previous LTGR assumptions may need to be revisited.

Despite the large increases in market volatility recently, implied market equity risk premiums (ERPs) and the ERP estimates used by most valuation practices increased by only 50 basis points over the past month. The ERP increase was largely offset by falling yields on the 20-year Treasury bond, often used as a proxy for the risk-free rate in cost of equity estimates. As a result, required equity returns have remained largely unchanged and may have even declined at the end of March.

Since the large declines in market capitalization cannot be explained by a higher equity return requirement, they appear to be largely attributable to lower expectations of future earnings growth. This places significant importance on updating forecasts to capture the impact of COVID-19 on expected business performance.

Unfortunately, in practice, it can take several weeks, if not months, for many companies to update long-term forecasts. Further, the extent of the economic impact of COVID-19 is largely unknown at this time. As a result, many companies may be forced to rely on projections that do not fully capture the impact of the recent market disruption. If left unadjusted, this could result in overstated business valuations. In order to avoid a potential overvaluation, it may be necessary to incorporate a COVID-19 CSRP in the cost of equity estimate. While this is less preferable than updating the projections, making adjustments to the discount rate may be the best option available while companies assess the impact of the economic downturn in the near term.

Based on our analysis of the recent change to the S&P 500 value, we estimate that approximately 200 basis points would need to be added to the cost of equity to account for the impact of COVID-19 on unadjusted forecasts. It is important to note that estimating the CSRP for a specific company can require a significant amount of judgment and each company will be impacted differently. For those companies significantly impacted by the pandemic, or more sensitive to market changes, the premium could be much higher. In addition, for those companies that have been relatively unaffected by the pandemic or have experienced an increase in demand for their products (i.e., surgical masks, consumer staples, cleaning supplies, etc.), the premium could be lower or not needed at all.

Incorporation of any CSRP should be qualitatively and quantitatively supported. As the size of the CSRP increases, a greater level of quantitative support will likely be required. For publicly-traded companies, this may include a discounted cash flow (DCF) analysis that calculates the company's internal rate of return (IRR) using pre-crisis forecasts and a current market capitalization. The CSRP implied by the IRR could serve as a reasonable proxy for the CSRP required in the discount rate of the company and its reporting units if their projections have not been updated.

Another potential approach to estimate the CSRP for private companies involves a shadow DCF analysis that uses a conservative forecast with minimal forecast risk.

This DCF value can serve as a hypothetical purchase price and be used to back solve to an IRR using the unadjusted forecast. Consistent with the above, the difference between the IRR and the baseline discount rate, without a CSRP, can serve as quantitative support for the CSRP assumption in valuing the company and its reporting units if their projections have not been updated.

In addition to the discount rate and financial projections, the LTGR is another assumption that may be impacted by the COVID-19 crisis. Many academics assert the yield on Treasury bonds serves as a reasonable proxy for the expected long-term, nominal economic growth rate of the U.S. economy. If this were to hold true, it would suggest that growth expectations have significantly declined in 2020 given the significant declines observed in Treasury yields. Benchmarking long-term growth to current Treasury yields may not be advisable in the current economic climate as it would infer negative real growth. However, the direction and magnitude of Treasury yields, among other economic trends, does suggest that long-term economic growth has been somewhat reduced. As a result, previous LTGR assumptions may need to be revisited.

Can a company use forward-looking valuation multiples in the current environment?

It depends. When applying the guideline public company approach, forward multiples, which are based on projected financial metrics, may sometimes be used to better incorporate future growth and profitability.

However, due to the significant amount of uncertainty in the current environment, many public companies have withdrawn their earnings guidance for fiscal year 2020. Earnings estimates by equity analysts may have also been withdrawn or could be stale. Given these dynamics, observable forward multiples may no longer be current or may be otherwise unreliable. As such, companies should be cautious when utilizing observable forward multiples and perform additional due diligence to assess their reasonableness. In particular, they should confirm the date of estimates and how the estimates have been updated following the crisis. In situations where reliable forward-looking analyst estimates can be obtained, companies must also be careful to ensure the subject company's projected financial metrics are also current.

Additional resources

Additional guidance, updates and news covering financial reporting impacts of the COVID-19 outbreak can be found here:

https://frv.kpmg.us/all-topics/coronavirus.html

For a more detailed look at financial reporting impairment considerations refer to Hot Topic—Increased risk of impairment of goodwill and long-lived assets available here:

https://frv.kpmg.us/reference-library/2020/coronavirus-related-impairment-nonfinancial-assets.html

Have questions?

Please contact your local KPMG adviser if you have additional questions or would like to suggest a topic for inclusion in a future FAQ document.

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